



February 1, 1966

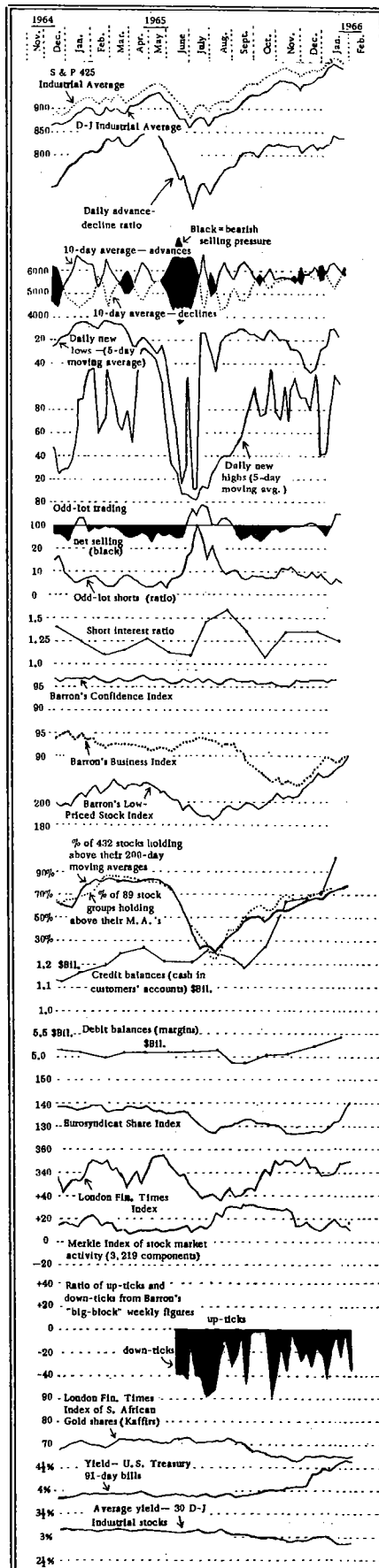
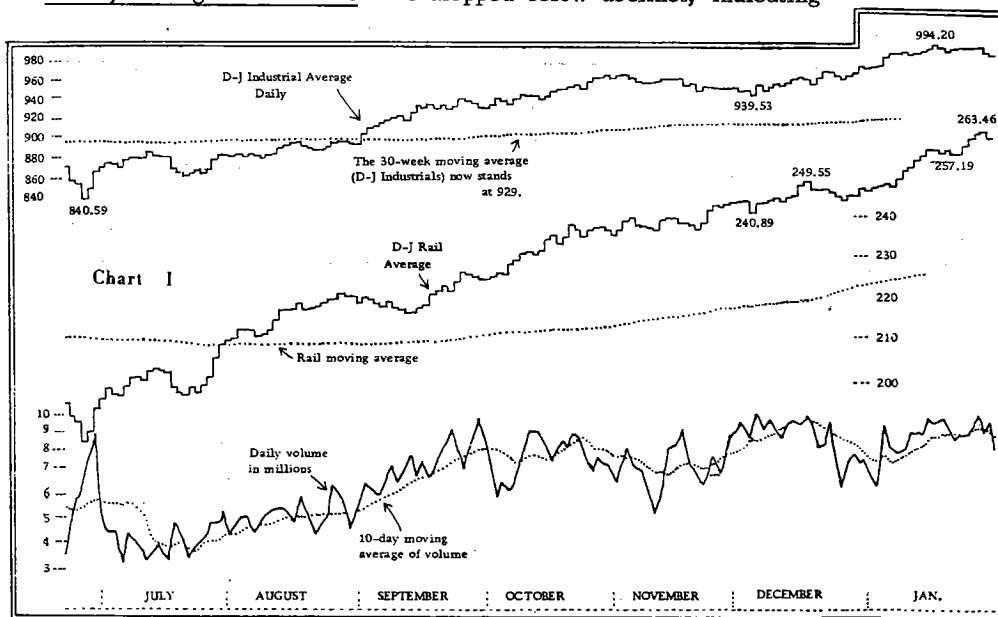
Letter 313

THE MARKET: The Averages always properly reflect coming events, wrote Robert Rhea, but it remains for us to read the Averages correctly. In the last Letter I noted that almost all important declines have been prefaced by some sort of hints in the Averages. While it is too early to know with certainty, the action of the market over the past few weeks could be hinting of trouble ahead. As I read it, the Rail Average has been surging to record highs reflecting increased sales and shipping for both civilian and military needs. Meanwhile, Industrials have been fluctuating within 15 points or so of the much-talked about 1000 level. Industrials appear to have "something on their mind," although that something could easily be resolved by a rally which would take the senior component to a new high.

Last week, in the face of the strong Rail performance and the desultory Industrial action, the Utilities sank to a new 1965-66 low. Since Utilities are directly affected by money rates, it seems to me that Utilities are now reflecting what every informed investor knows, that the U.S. Government is in the process of running up massive new deficits. The cost to the Treasury for financing these deficits is going to be 5% or more. Thus U.S. business is faced with direct competition for high-priced money from the most voracious money-user the world has ever seen.

What are the near-term checkpoints? On January 18 the Industrial Average recorded an all-time high of 994.20. Since then, Rails have continued to push to successive record peaks, but Industrials have refused to confirm. From the bullish standpoint, an Industrial bettering of 994.20 would confirm recent Rail strength and constitute an "all clear" signal. On the other hand, on January 28 the Industrials penetrated their January 20 minor decline of 988.14. This produced the first downward zig-zag in the Industrial Averages since November. The comparable downside point on Rails is the 259.19 low of January 19. If Rails break through the 259.19 level they would be confirming Industrial weakness. This would be the first indication of potential trouble ahead.

The Composite Chart shows the two leading Industrial Averages hesitating a few percentage points below their all-time highs. The advance-decline ratio has stalled just under its May, 1965 high, and it will now be of great importance to see whether the May peak is to prove a mere temporary barrier or an insurmountable obstacle. The 10-day average of advances has dropped below declines, indicating



Page 2 the beginning of selling pressure. Odd-lots have continued on the buying side, and another week or so of this would suggest technical deterioration. Barron's Confidence Index has climbed to 97.4 again, just a fraction under its bull market high of 97.6 Customers' Free Credit Balances rose to a record high of \$1.66 billion in December. This is bullish since it indicates that customers have built up large quantities of cash in their accounts (this cash is usually spent at bull market tops). Debit Balances or margin accounts rose to \$5.54 billion in December, just under the record 1963 peak of \$5.62 billions. This is bullish since it indicates a rise in speculators' equity positions. The Eurosyndicat index of the 100 largest Common Market nations touched 140 last week, thus showing the greatest strength in two years.

Conclusion: Except for persistent odd-lot buying and a continued lag in the Standard & Poor 500 Average (the latter puts the disparity ratio in dangerous territory) the general technical structure of the market appears strong. There is no question in my mind, however, but that the public is now coming in heavily (December mutual fund ratio dropped to 37, showing very heavy buying in funds). It is now a question of "how hot is hot." The market is boiling, and boiling water can inflict dangerous burns.

1966: In general, I try to offer three things to readers of these Letters. (1) interpretation of the Averages according to Dow Theory together with appraisals of the general technical condition of the market, (2) information about anything which may affect our investments and our money together with historical perspective, (3) personal opinions about events which may affect our financial status.

The following belongs in category 3, my own opinion as to what to expect in the period ahead. (A) I expect a monetary crisis ahead and soon. The massive Great Society spending programs have converged with huge Vietnam spending needs. This is going to bring on a series of shocking deficits. As the current scramble for money intensifies, interest rates (which are now at extremely high levels) are going even higher. On January 26 the Treasury announced that it was refunding \$28 billions of existing notes at rates of 4 7/8% and 5%, the highest rates since 1959. I believe that another rise in the discount rate is a distinct possibility. From almost every quarter of the financial world we hear reports of new rate increases. The upward spiral in money rates is accelerating.

(B) I believe that the Communists are fully aware of the U.S. financial predicament. Therefore, they will not find it to their interest to settle the Vietnam war at present. Time is on their side, as they see it. It is well to remember that the Communists (ironically) view capitalism from an orthodox (pre-Keynesian) standpoint, and the Chinese in particular have always been fiscal conservatives. So far, the war has cost Russia and China nothing but Vietnamese casualties and dead; it is costing the U.S. billions of dollars and this at the top of a boom. The Chinese would like to keep it that way.

(C) The U.S. is in a position where the bigger the deficits, the greater the coming deflation. Budget deficits have to be financed at this point by higher interest rates or higher taxes or both. So far, the business world has taken the deficits to be inflationary. This appraisal is due to change.

QUOTES AND COMMENTS: I would guess that 99 out of 100 investors still do not grasp the significance of the sky-rocketing interest rates, but I insist that my own subscribers understand the money situation. Each month \$billions in bank certificates of deposits fall due and have to be renegotiated at current rates. On January 12, major N.Y.C. banks offered 5% for C/D's. The implications of this new rate are startling. It costs the banks an additional .2% for reserves in the Fed and another .5% for overhead or a total of 5.7% for this new money. Yet the average return on all loans at N.Y.C. banks is around 5.3% while the prime rate (i.e., rate to the top customers) is 5%!

Commenting on this situation in his new January letter (Alden R. Wells Monetary Report), Wells says: "Five percent for C/D's seems about the limit for major city banks. We believe that even this limit is turning bankers to liquidate loans and investments. A net of \$743 million was liquidated by New York banks last week. Probably plans call for an orderly liquidation of C/D's at this level of interest. On the other hand, if the bill rate does pass 5%, the liquidation might become hasty. A senior economist of a major bank told us, 'If we can get by the end of March, we will be all right.' By the end of March, in our opinion, the nation will never be the same again."

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Late figures indicate that the U. S. stockpile of silver continues to drop. Between December, 1964 and December, 1965 the U. S. lost 1/3 of its total silver stock. Dr. Franz Pick believes that silver could ultimately climb in the free market to \$2 or \$3 per ounce. But historically, there has been a definite ratio between the price of silver and gold; the ratio has run from 15 to 16 to 1. With this in mind, Dr. Pick writes: "Any increase in the silver price would have a major bearing on the gold problem, which as a result of its 33 years of mis-management has created sufficient aggravations for the Treasury. A silver price jump would immediately lead to a gold panic in London and to substantial gold losses which, in turn, could generate a gold embargo, culminated by a doubling or trebling of the present fictitious gold price of 35 Paper Dollars per ounce. Yet despite all these great risks, the silver management of Washington will not be able to hold the metal's price at its current level."

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Anyone who watched Secretary of State Dean Rusk on the Telstar TV interview on January 24 must have noted his oft-repeated genuflections towards Mr. Johnson. It is obvious that not a move is made without the President's approval. But as all decisions are made at the top, all pressures also pile up at the top. The wishes of the President are now in the open. He would like (1) to negotiate the Vietnam war away. (2) Failing this, he would like to de-escalate the war to something politically palatable and financially feasible. If I know this, then the other side knows it too. Therefore my best guess is that the enemy will not aim to please. The probable result: LBJ will have to choose between "more of the same" or back to escalation. With the money situation going the way it is, I do not see this as bullish for the stock market. But as Hamilton warned, I could be "right too soon."

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(From an interview with James Reston, assoc. editor of the N. Y. Times and former head of the Times's Washington Bureau): "We are just at the beginning of an enormous battle of Asia. That battle will go on for the rest of the century and Vietnam is not the end of it but the beginning. If we win in Vietnam, the battle will still go on, and what I am afraid of is that we will try to score a great smashing victory, thinking that will end it all, which it won't. Therefore, I would limit the objective."

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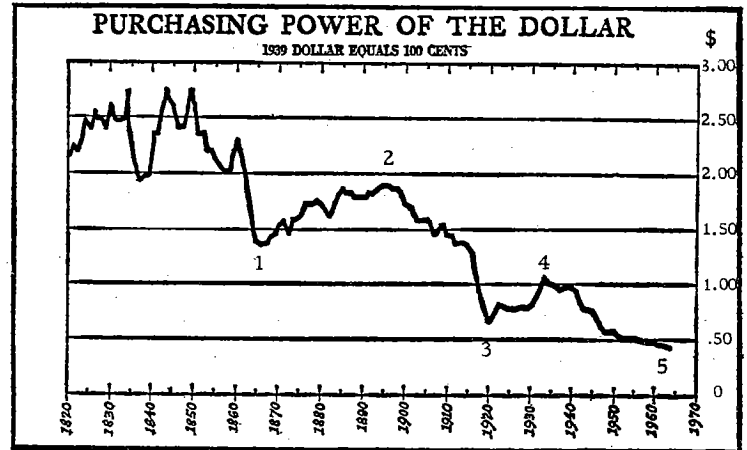
Changing times: "The Bonn Republic (Germany) has displaced Britain as the third greatest industrial power and is now the second greatest exporter of industrial goods." (N.Y. Times, Jan. 21, 1966).

(D) On January 31 it was announced that U.S. bombing of N. Vietnam had resumed. The appeasement of the doves is over, and the U.S. will now attempt, as one General put it, "to bomb North Vietnam into the stone age." My prediction; an all-out Congressional debate and a hardening of world opinion against the U.S. It will now be a test of U.S. resources against Communist nerves. Two of the winners will be the twin D's, death and deficits.

(E) Subsequent events have underscored the wisdom of Reserve Board Chairman Martin's boosting of the discount rate. The latest careening figures on the cost-of-living have even silenced the Democrats. I believe that Johnson now definitely wants to keep Martin "in control," and that Johnson's new appointee to the Board will be a Martin man. As a side thought, as long as Martin is in control, LBJ can blame any forthcoming trouble or deflation on Martin.

CHART OF THE WEEK: The accompanying chart is interesting from two standpoints. First, the chart shows the major erosion which has taken place in the purchasing power of the dollar since 1920. The only period in modern history during which the buying power of the dollar actually increased was during the 1920-32 era. Prior to 1920 and since 1932 the picture has been one of loss for savers and those who owned anything of "fixed" value such as an insurance policy, a bond, an annuity or a pension.

The second point of interest is theoretical but I think worth commenting upon. I have often discussed the Elliot Wave thesis of completed primary movements occurring in five distinct legs, three legs in the direction of the main movement and two corrective legs against the main movement. Although this theory is obviously not infallible, I have seen it work again and again.



One of the things which struck me about this chart was that the decline in the dollar's purchasing power is now on a distinct fifth primary leg. The fifth leg is about as long as the first and third and could be near completion. If this is true, then we could be on the edge of a major upward correction of the entire decline in the purchasing power of the dollar. This is, of course, all highly theoretical, but if such a "correction" did occur, it would correspond with deflation and a major resurgence in the purchasing power of the dollar. It's an interesting contrary opinion.

STOCKS: Gold and silver (monetary metal) shares have been moving up since November; the move has accelerated in 1966. On January 31, as bombing of Vietnam resumed and as peace hopes evaporated, the gold rose sharply. American-South African touched 71 on that day, after rallying 19 points without so much as a three point correction. Dome and Campbell are pushing their highs again, and one could almost "feel" the money moving into the protective position of golds. South African shares have also been rallying, reflecting steady buying on the Johannesburg exchange. American Depository Receipts usually follow Johannesburg prices a week or so later, and last week it was interesting to see President Brand hit an all time high in Johannesburg.

Simultaneously with the rise in gold, the U.S. entered talks with 10 leading nations in Paris regarding a new international reserve currency. The stepped-up hoarding of gold throughout the world is now causing a marked contraction in world liquidity, and the U.S. efforts to retain its own dollars has aggravated the situation. The French want to base any new currency on the size of the participating nation's gold reserves, an idea which the U.S. looks upon with obvious horror. It should be an interesting but frustrating session for the U.S., and back of it all will undoubtedly be the casual mention by sundry European powers of a possible multi-lateral boost in the price of gold.

An interesting aside is that renewed gold buying has come in from Red China (in the London Market). This prompted the London Economist to note "The

SOUTH AFRICAN GOLD SHARES: A great many of my subscribers are holding gold shares, but because it is often difficult to obtain late information on the progress of leading S. A. gold shares, I have adopted the policy of periodic reviews of earnings. Blyvooruitzicht (price 3½) for year ending June 30, 1965, showed a working profit decline of 11%, but uranium royalties raised net income 17% to 64¢ per share. Dividends are 32¢. (Remember, all non-residents of S. Africa have 7½% of dividends withheld as a tax, but U. S. taxpayers may take a tax credit on this).

Free State Geduld increased working profits 12% in year ending Sept. 30. Earnings rose 5.5% to \$2.07 per share, while the dividend was raised from \$1.33 to 1.52. Because of half interest in Freddies Cons., Free State could boost dividends again this year.

President Brand showed net income of \$1.30 vs. 1.21 for the year ending June 30. The dividend was increased to 91¢ from 88¢. Pres. Br. recently acquired for cash another mine, Free State Saaiplaas, from which benefits should be forthcoming.

West Driefontein, S. Africa's largest producer, showed a 14% rise in working profits for the year ending June 30. Earnings were \$1.73 vs. 1.64 for 1964. Dividends were 95¢ vs. 83¢ in '64. Further dividend increases are in prospect as large capital expenditures are reduced.

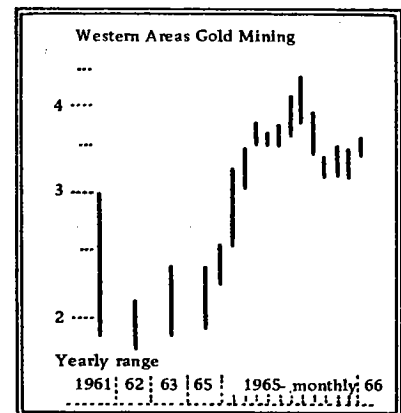
Western Deep Levels, destined to be world's greatest gold mine. For the first 9 mos. of 1965 Western Dp. gained 17% in tons milled and final net was up 56%. Earnings were 56¢ for the 5.6 million "A" shares and 19.4 million "B" shares combined as against 35¢ last year. Once the A shares receive total accumulated dividends of \$1.40, both shares will receive dividends equally. The B shares will probably begin receiving dividends this year.

There is a 15% interest equalization tax on all of these shares unless they are purchased from another U. S. citizen. Most of these shares may be purchased via American Depository Receipts, and all are quoted daily in the "Foreign Securities" box in the Wall Street Journal.

These shares have faced the Rhodesian crisis, the great British devaluation "escape," and the "gold-saving offensive" of the Great Society. They touched their lows last November, and they have been edging up ever since.

buying represented not a switch out of sterling, but out of Swiss francs. China has apparently been accumulating them in greater quantity than was generally suspected. "This gold buying fits in with the writer's thesis that China is fighting an economic war with the U.S., and that she wants ultimately to compete with capitalism in the marketplace. China's unannounced motto might be, "Keep buying gold while the U.S. loses her own gold."

I have recommended a fairly new South African gold mine on a number of occasions; this mine is Western Areas (which started production in 1961). Western Areas has just declared its first dividend (7¢), it is a growth mine, and I believe that it represents good value at the current bid price of around 3.60. I have included a chart of Western Areas, and here we see W.A. selling in the middle range of its average price of the past year. Of interest is the fact that American-South African Trust purchased 174,000 shares of W.A. during 1965, raising its total position to 200,000. W.A. earned approximately 28¢ last year and earnings could move up to 33¢ or better in 1966. I continue to recommend this stock (the writer has a small position in Western Areas).



In the silver area, I have recommended Day Mines in the past and continue to feel that this domestic silver and gold producer is well worth holding. I direct subscribers' attentions to Sunshine Mining, one of the largest silver producers in the U.S. The stock has formed a huge "head-and-shoulders" base, and on January 24 it gave a "buy signal" at 33. I show Sunshine more as a point of interest than a buy recommendation, and I would rather put new money into golds which have fat earnings behind them than silvers which are selling in most cases at very high P/E ratios.

SALES: In past Letters as far back as a year ago I recommended the sale of all money-based stocks, finance companies, banks, savings and loan holding companies, small loan companies. Sale of these stocks was based on my studies which suggested a vast tightening of money rates. Most of these stocks are now far below their price of a year ago, and the sales were obviously justified.

I now advocate the sale of a second broad group of shares, the retail stores. I include weekly charts of six huge retail concerns. These six are representative of most of the stocks in the group. With credit providing the impetus behind the explosion of sales in the U.S., it becomes increasingly apparent that tightening money means costlier credit. Costlier credit is going to mean a squeeze on retail sales, and the investment issues in the group are already reflecting this. In my opinion, General Motors, the biggest producer of consumer products in the world, is also reflecting sales problems ahead. I have already recommended the sale of auto shares.

Last week a subscriber called to say: "I have about 20% of my assets in assorted gold shares, and perhaps 60% of my money in 91-day Treasury bills. I feel that I am well protected against almost any emergency in the period ahead. But you say yourself that calling the top of a speculative bull movement is next to impossible. Suppose I am willing to speculate on a few stocks, with the idea of running if the market cracks, but also with the idea of hedging against a final sort of blue-chip blow-off. Which stocks would you recommend?"

I would probably repeat my recommendation of Aluminum Co. of America (Letter 212) plus Westinghouse. These are two of the strongest Dow stocks, and it is usually the Dow stocks (in a final spurt) which wind up a bull move. Alcoa has moved up about 4 points since Letter 212, but Westinghouse has been marking time for the past three months. Both AA and WX are war-oriented stocks, and speculators should buy them only if they have plenty of cash and at least 20% of gold shares in their portfolios.

Small weekly charts on this page courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas

